Highlights

Extended Fund Facility Arrangement of the International Monetary Fund (IMF-EFF) to Sri Lanka

Last 12 months: Economic Milestones

LKR depreciated on 7th March 2022

Shortage of essentials – fuel, gas etc.

External Debt Default in April 2022

No real Bridge finance except specific import financing – e.g. World Bank- Gas and Fertilizer, India – Fuel

Pursuing Staff level agreement – took 6 months from March 2022 to September 2022

Relative Stability – availability of goods by 4Q 2022

From 1Q 2023- Banks have dollars but significant slowdown in economic activity

IMF Board Approval – 20th March 2023

48 Month EFF

of

SDR 2.286 billion
(about USD 3 billion)

Key Objectives of the Programme

1. Restore macroeconomic stability and debt sustainability
2. Safeguarding financial stability
3. Stepping up structural reforms to unlock country’s growth potentials

First Tranche to Receive Immediately

Initial disbursement of about **USD 330 billion** will be received immediately and it is expected to catalyse new external financing

Expected support from Multilaterals

Total inflows from the IMF, World Bank and Asian Development Bank (ADB) is **likely to be USD 1.5 billion in 2023**

Bi-annual Programme Reviews

There will be two reviews per year in **June and December from 2023 to 2027** and disbursements in equal instalments during September and March respectively.

Measuring the Progress

Progress of the programme will be monitored through quantitative performance criteria (QPCs) and Indicative Targets (ITs).

Growth Expectations

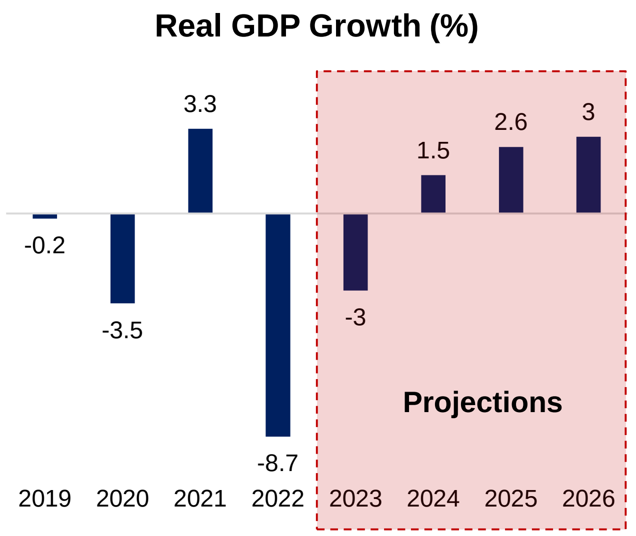
IMF assumes that the Sri Lankan **economy will contract by 3% in 2023 and then grow by 1.5% in 2024**. They highlight that the growth will need to complemented by reforms related to SOEs, electricity sector, capturing the opportunities for women and youth and through climate change initiatives.

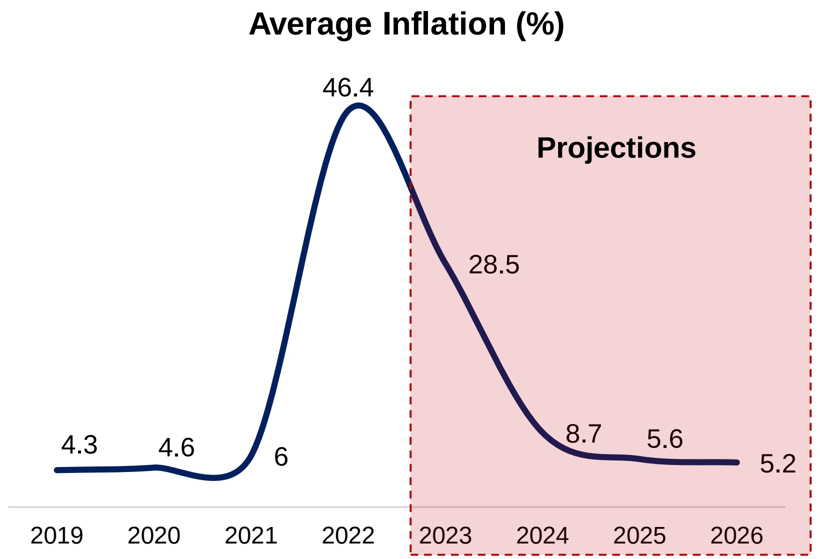
Expected Progress to Receive the Second Tranche

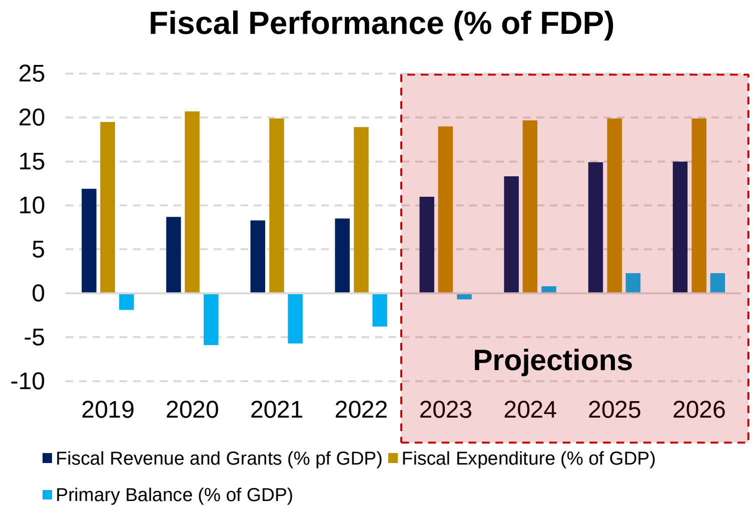
- Parliamentary approval of the welfare benefit payment scheme and application criteria for low-income welfare payments
- Cabinet approval of comprehensive strategy to restructure the balance sheets of the CEB, CPC, Sri Lankan Airlines and Road Development Authority
- Parliament approval of New Central Bank Act by April 2023
- Asset quality reviews (AQRs) for two largest state-owned banks and the three largest private banks by April 2023.\
- Cabinet approval of a full revision of the Banking Act in consultation with IMF staff - April 2023
- Enact new anti-corruption legislation to harmonize it with the United Nations
- Convention Against Corruption, pending comprehensive asset recovery provisions, in consultation with IMF staff - end June 2023

Key Economic Indicators-Projections

Indicator	2019	2020	2021	2022	2023	2024	2025	2026
	Act.	Act.	Act.	Prel.	Proj.	Proj.	Proj.	Proj.
Real GDP Growth (%)	-0.2	-3.5	3.3	-8.7	-3	1.5	2.6	3
Average Inflation (%)	4.3	4.6	6	46.4	28.5	8.7	5.6	5.2
Fiscal Revenue and Grants (% pf GDP)	11.9	8.7	8.3	8.5	11	13.3	14.9	15
Fiscal Expenditure (% of GDP)	19.5	20.7	19.9	18.9	19	19.7	19.9	19.9
Primary Balance (% of GDP)	-1.9	-5.9	-5.7	-3.8	-0.7	0.8	2.3	2.3
Public Debt (% of GDP)	89	104	114.3	128.1	111.2	108.5	107.8	106.8
Reserve Money (% change)	-3	3.4	35.4	3.3	23.5	11.2	7.3	8.4
Current Account Balance (% of GDP)	-2.1	-1.4	-3.8	-1.9	-1.6	-1.4	-1.4	-1.4
Gross Official Reserves (end period in USD Mn)	7,642	5,664	3,139	1,898	4,431	6,128	8,520	10,888
Usable Gross Official Reserves(end period, USD Mn)	7,642	5,664	1,565	462	2,995	4,692	8,520	10,888
External Debt (Public and Private, % of GDP)	61.4	62.6	64.4	78	74.7	76.7	78	78.6







Programme Objectives-In Detail

Advancing Revenue-Based Fiscal Consolidation, Reforms to Social Safety Nets, Fiscal Institutions, and State-Owned Enterprises

One of the major issues that Sri Lanka faced was persistent large fiscal deficits that reached 12.1% of GDP in 2020 and 11.6% of GDP in 2021.

To address this, the program aims to implement wide-ranging

- **Tax reforms**
  - Raising the marginal PIT rate schedule, raising fuel excises, reducing the PIT tax-free allowance
  - Raising the statutory CIT rate, raising the VAT rate
  - Revamping the VAT system, speeding up valid VAT refunds, abolishing the Simplified VAT (SVAT) system, and introducing a property tax and gift and inheritance tax.
- **Revenue administration reforms** aim to strengthen PIT collection efficiency, tax collection efficiency, and enhance fiscal transparency.
- **Expenditure rationalization measures**
  - Develop strategies to limit growth in the public sector wage bill and public pension spending.
  - Restrain wage and pension increases to well below inflation in 2023
  - While excessive cuts to capital spending should be avoided under the program, fiscal space for capital spending will be constrained

Strengthen the governance of SOEs and address their debt overhangs

SOE reforms will include:

- cabinet approval of a comprehensive strategy to restructure the balance sheets of the CPC, CEB, the Road Development Authority, and Sri Lankan Airlines by June 2023
- prompt publication of audited financial statements for all 52 major SOEs
- prohibition of new FX borrowing by non-financial SOEs with limited FX revenues
- clarifying the mandates of key SOEs through Statements of Corporate Intent, and by reviewing the framework for selecting SOE board members.

The program aims to strengthen the social safety nets (SSN) to help cushion the impact of the economic crisis on the poor and vulnerable - will set a floor on SSN spending of LKR 187 billion in 2023. Beyond 2023, the authorities will maintain SSN spending at least at 0.6-0.7 percent of GDP.

The authorities will strengthen the core public financial management (PFM) functions.

- Enacting a new PFM law, which clarifies the budget process, specifies the roles of government agencies, and includes a revamped fiscal rules framework, with submission to Parliament by December 2023
- Developing a medium-term fiscal framework to provide binding multi-year fiscal policy guidance
- Completing the rollout of the Integrated Treasury Management Information System (ITMIS) by September 2023
- Strengthening the recently established Macro-Fiscal Unit in the MOF
- Improving public investment efficiency by strengthening the processes for project appraisal and selection
- Updating fiscal reporting to the GFSM 2014 standard

Introduced automatic fuel and electricity pricing mechanisms, paving the way for resolving debt overhangs and low efficiency in the energy sector.

- Retail fuel prices will be set to their cost-recovery levels with monthly formula-based adjustments
- The end-user electricity tariff schedule will be set to its cost-recovery level with semi-annual formula-based adjustments
- The cost of non-commercial obligations of the CPC and the CEB will be compensated by government transfers

Restoring Public Debt Sustainability

The authorities are committed to restoring debt sustainability. Their objectives are to:

- reduce the level of public debt below 95 percent of GDP by 2032
- reduce average central government gross financing needs (GFNs) in 2027–32, including from the materialization of contingent liabilities, below 13 percent of GDP, so that rollover risks under stress are manageable
- keep FX debt service of the central government below 4.5 percent of GDP in any year during 2027-32
- ensure that the fiscal and external financing gaps are closed

**The authorities are committed to improving public debt management and debt transparency - ** They will establish an operationally independent debt management agency and have begun to publish a quarterly debt bulletin.

Restoring Price Stability and Rebuilding External Buffers

The CBSL is committed to restoring Sri Lanka's price stability through maintaining tight monetary stance and discontinuing monetary financing

The authorities are firmly committed to allowing greater exchange rate flexibility and rebuilding international reserves

The authorities have tightly restricted FX flows in response to the sharp currency depreciation and pressures on reserves, and these temporary FX control measures are expected to be unwound during the program period once conditions allow

The institutional framework will be strengthened to support flexible inflation targeting and greater exchange rate flexibility - Central bank autonomy will be strengthened by enacting the new Central Bank Act with critical improvements over the current Monetary Law Act

Ensuring Financial Stability

The program envisages measures to adequately recapitalize the banking system - The CBSL has hired two internationally reputable independent specialist firms to conduct a diagnostic exercise for nine major banks, including a comprehensive asset quality review

There is an urgent need to strengthen financial sector supervision, safety nets, and crisis management capacity - The Banking Act has been approved by the cabinet, which will strengthen banking resolution tools for the CBSL to deal with potential bank failures efficiently and improve funding arrangements. A full revision of the Banking Act is expected by June and December 2023.

The regulatory and governance framework for state-owned banks will also be strengthened - The Banking Act will ensure that the state-owned banks meet the same regulatory requirements as private banks, including on large exposures, related party lending, and governance

Heightened supervision of the smaller non-bank deposit-taker sector (8% of deposit-taker assets) will continue - with steps taken to tighten non-performing loan classification and capital requirements in line with requirements for banks, and liquidating five leasing companies whose licenses had previously been suspended

Reducing Corruption Vulnerabilities

Strengthening Sri Lanka's governance and anti-corruption framework is crucial to restore and sustain long-run economic, social, and political stability

- An IMF governance diagnostic mission has started to assess Sri Lanka's governance and anti-corruption framework, which will be published by September 2023. The report's findings will help identify specific priority and time-bound reforms to be implemented under the program
- The authorities are upgrading the anti-corruption legislation to ensure harmonization with the United Nations Convention against Corruption (UNCAC), supported by IMF CD
- The authorities are also committed to improving the timeliness and accuracy of fiscal data. An online transparency platform will be established to enhance transparency of debt, public procurement contracts, and tax exemptions
- The authorities should sustain efforts to strengthen their AML/CFT regime

Raising Potential Growth

- The authorities will develop a medium-term plan to rationalize para-tariffs to liberalize Sri Lanka's highly protective trade regime.
- Targeted reforms are needed to boost female LFP and reduce youth unemployment.
- Reforms to strengthen State-Owned Enterprise (SOE) governance, adopting digital technology, promoting access to digital platforms for SMEs, improving the private sector's access to land, upgrading labor skills, and enhancing labor market flexibility are essential to improve private firms' competitiveness.
- Structural reforms in the electricity sector should be urgently pursued with technical support from development partners to reduce Sri Lanka's high electricity cost and address large investment needs in generation and transmission.
- Sri Lanka should strengthen efforts to adapt to climate change, including through contingency budgeting and insurance schemes for natural disasters.